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No. 10

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In the Supreme Court of the United States

OCTOBER TERM, 1954

THE UNITED STATES, PETITIONER

v.

OLYMPIC RADIO AND TELEVISION, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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to stop the running of interest against the taxpayer. The initial *Rosenman* payment was found not to be a tax payment despite the fact that the Court recognized that it stopped penalties and, as the Government conceded, interest *against the taxpayer*. It was found not to be a tax payment because it gave rise to no interest claim *against the Government*. The situation here is no different. Nor do we find such decisions as *Hanley* v. *United States*, 63 F. Supp. 73 (Ct. Cls. 1945), inconsistent with our conclusion, for there the taxpayer did not negative "payment" by simultaneous contest. Cf. *Murphy* v. *United States*, 78 F. Supp. 236 (S. D. Calif. 1948).

We hold that the 1947 remittances did not constitute "payment" of the taxpayer's 1943, 1944 and 1945 tax liabilities. They were no more than deposits "made in the nature of a cash bond for the payment of taxes thereafter found to be due." *Rosenman*, at p. 662.

The taxpayer also argues that the Tax Court's order entered on the 1948 stipulation settling the 1943 excess profits tax liability binds the Government by way of collateral estoppel from now asserting that the 1947 remittance in respect of the 1943 tax was not a payment of the tax. We need not dwell on this contention. It seems clear (although the pleadings are not before us) that the settlement was concerned only with the *fact* of payment and not with its *date*. The item in the stipulation "Tax paid: September 29, 1947 (3rd NY)" does not persuade us that the question we now have before us was really at issue in the Tax Court.

2. *1947 Interest Payments*

For the same reasons the taxpayer's contention as to the deductibility of the 1947 interest payments in respect of 1943, 1944 and 1945 taxes must also fail.

3. *1946 Net Operating Loss*

The taxpayer challenges the determination of the Commissioner and the Tax Court as to the amount of the 1946 net operating loss.

As determined below, the net operating loss for 1946 was $164,326.38. The taxpayer argues that it should have been increased by $861,118.04, being the amount of the excess profits taxes which it paid in that year in respect of 1945.

This requires us to interpret the phrase "paid or accrued" in § 122(d)(6) permitting the deduction of excess profits taxes "paid or accrued within the taxable year" in the computation of the net operating loss under § 122(a). As already noted, it was unnecessary to reach this problem with respect to the 1947 net operating loss. The Tax Court held that "paid or accrued" meant that a *cash* taxpayer was entitled to deduct only excess profits taxes "paid," and an *accrual* taxpayer only those "accrued," within the taxable year, and that since Lewyt was an accrual taxpayer this sum of $861,118.04 could only be reckoned in Lewyt's tax computations for 1945. We think the Tax Court was right.

We start with the statute itself. Section 48(c), I. R. C., 26 U. S. C. A. § 48, provides that "when

used in this chapter" (that is Chapter 1 entitled "Income Tax") "the terms * * * 'paid or accrued' shall be construed *according to the method of accounting upon the basis of which the net income is computed under this Part* [IV "Accounting Periods and Methods of Accounting"].[3] See also T. R. 29.43-1. Section 43, I. R. C., 26 U. S. C. A. §43, captioned "Period for which deductions and credits taken," states: "The deductions and credits * * * provided for in this chapter [1] shall be taken for the taxable year in which 'paid or accrued' * * * dependent upon the method of accounting upon the basis of which net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

The taxpayer makes a number of arguments to avoid what we think to be the plain effect of these provisions. We consider first its argument based on legislative history. Section 202(a) of the Revenue Act of 1941 amended §23(c) of the Internal Revenue Code to permit deduction of Chapter 2E excess profits taxes "paid or accrued within the taxable year" in computing net income, subject to certain rules provided in §23(c)(2), one of which, "A," stated: "The deduction shall be limited to the tax *imposed* for the taxable year, but any portion of such tax paid *after* the taxable year shall be considered as having been paid *within* the taxable year * * *" The taxpayer here points out, and

[3] All italics in this opinion have been supplied.

we think correctly, that this last quoted provision in effect placed cash and accrual taxpayers substantially on an *accrual* basis so far as the excess profits tax deduction was concerned. Then came the Revenue Act of 1942 which by §105(c) eliminated Chapter 2E excess profits taxes as a deduction in computing net income, but added, by §105 (c)(3)(C), a new Section, §122(d)(6), permitting the deduction of such excess profits taxes from gross income in computing the net operating loss, and net operating loss "carry-backs" and "carry-overs," subject to rules which were the same as those presently contained in §122(d)(6).

Pointing out that these rules are substantially the same as those formerly contained in §23(c) (2) as amended by the Revenue Act of 1941, except that rule "A" of that section, quoted above, was omitted, the taxpayer argues that one of two inferences should be drawn—either that the Congressional intent was that the basis of deductibility of excess profits taxes should follow the taxpayer's method of accounting, *i.e.*, cash or accrual, or that in this respect the Act gave a taxpayer, whether cash or accrual, an election to deduct such taxes if either paid or accrued. It is urged that the latter inference is the more compelling, it being argued, as we shall see in a moment, that to draw the first inference would attribute to Congress an intention to "discriminate" between cash and accrual taxpayers, in that an accrual taxpayer, absent such election, would rarely be able to take an excess profits deduction in a "loss" year.

We think that without more the arguments for and against these opposing inferences would at best present a stand-off. But we need not pause to examine them further, for here we have the explicit direction of §43 that this deduction "shall be taken for the taxable year in which 'paid or accrued' * * * *dependent upon the method of accounting upon the basis of which net income is computed*, unless in order to reflect the income the deductions * * * should be taken as of a different period." Certainly the exception would have no application in this instance, and it appears not to be contended to the contrary.

Next, we are referred to *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (D. C. Cir.), *cert. denied* 325 U. S. 881 (1945), and a line of cases following it, *Birmingham* v. *Loetscher Co.*, 188 F. 2d 78 (8th Cir. 1951); *Aramo-Stiftung* v. *Comm'r*, 172 F. 2d 896 (2d Cir. 1949); and *Wm. J. Lemp Brewing Co.* v. *Comm'r*, 18 T. C. 586 (1952), holding that the provisions of former §356, I. R. C., now §505(a)(1), I. R. C., 26 U. S. C. A. §505, permitting the deduction of excess profits taxes "paid or accrued during the taxable year" in computing the surtax upon the undistributed net income of personal holding companies under §500, I. R. C., 26 U.S.C.A. §500, gives a taxpayer, whether cash or accrual, the option of taking this deduction on either basis. The ground of these decisions, as exemplified by *Clarion*, is that the provisions of §48(c) in Chapter 1 of the Internal Revenue Code defining "paid or accrued" in terms of a taxpayer's method of re-

porting for the purpose of computing *net income* under that Chapter, have no application to the meaning of §505(a)(1) permitting deduction of excess profits taxes for the purpose of computing the *undistributed income* tax on personal holding companies under Chapter 2. "But, obviously, this definition [48(c)] was intended to apply to the method of computing *net income*, and has no reference or relevancy to the subject matter of what, for the purposes of the newly added provision in relation to personal holding companies is taxable as *undistributed* income." *Clarion*, at p. 675. Stated otherwise, Chapter 2 contains no provisions comparable to §48(c) and §43 of Chapter 1 defining the phrase "paid or accrued."

The *Clarion* and the other cases cited are inapplicable to the one before us. Here the meaning of "paid or accrued" in §122(d)(6) is directly involved in the computation of *net income*, for §23(s) allows as a deduction in "computing net income" under §23 "the net operating loss deduction computed under Section 122." In addition, to the extent that the meaning of "paid or accrued" is involved in the computation of the net operating loss itself by application of the §122(d)(6) deduction, §43 specifically gives it the same meaning as §48(c) requires in connection with the computation of net income.

The third contention which the taxpayer presses upon us is that to construe §122(d)(6) as we do discriminates against the accrual taxpayer. The argument is that in the nature of things it is usually

impossible for a taxpayer to incur in the same year both an excess profits tax liability and a net operating loss. Therefore, it is said, an *accrual* taxpayer in most cases will be unable to get the benefit of the §122(d)(6) adjustment in calculating his net income, while a *cash* taxpayer normally will. Take this hypothetical situation as illustrative of the taxpayer's point. A corporation had high profit years in 1942 and 1943 and incurred a $1,000,000 excess profits tax liability in the latter year, which it paid in 1944. In 1944 it had a net operating loss of $500,000, without regard to any §122(d)(6) adjustment. If an *accrual* taxpayer, the corporation would not be able to add its excess profits taxes for 1943 to its net operating loss for 1944; if a *cash* taxpayer, it would; and this in turn would mean that the cash taxpayer's net operating loss "carry-back" to 1942 and 1943 under §122(b)(1) would be increased by $1,000,000, whereas the accrual taxpayer's "carry-back" would remain at $500,000.

We may conceive of situations where the accrual taxpayer is not put at this disadvantage with the cash taxpayer. One such is a situation where, as in the case of this taxpayer's 1943 excess profits taxes, accrual of the excess profits tax liability has been postponed because of a dispute concerning it, and the time of payment and accrual therefore coincide. See *Robert Reis & Co.* v. *Comm'r*, 20 T. C. 294 (1953). Nevertheless, we would not be candid if we failed to recognize the force of what the taxpayer argues here. But however sympathetic one may be to this predicament of an accrual taxpayer—

a phenomenon by no means unique under the tax laws—we would not be justified in ignoring the plain mandate of the statute.

Finally, on this point the taxpayer gives us the decision of the Court of Claims in *Olympic Radio and Television, Inc.* v. *United States*, 108 F. Supp. 109 (1952), *re-hearing denied* 110 F. Supp. 600 (1953), which squarely upholds the position of the taxpayer as to the meaning of "paid or accrued" in §122(d)(6). We have given careful and respectful consideration to the two opinions of the majority in that case, which were based largely on the same considerations urged upon us by the taxpayer here, and find ourselves unable to agree with the Court of Claims.

4. *1946 Net Operating Loss "Carry-Back"*

Now we come to the issue involving the "carry-back" of the 1946 net operating loss to 1944 and 1945. As previously noted, §122(b)(1) requires that such loss be applied first to the year 1944 and the excess, if any, to 1945. That excess is the amount by which the 1946 operating loss exceeds the income for 1944 "computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6) [of §122] *and* (B) by determining the net operating loss *deduction* for such second preceding taxable year [1944] without regard to such [1946] net operating loss." §122(b)(1) and §122(c).

In terms of the present case, the situation is this: The taxpayer's 1944 income, as to which there is

no dispute, was $584,866.81, *without regard* to any §122(d)(6) adjustment or the 1946 net operating loss deduction under §23(s). There was no net operating loss for 1944. The net operating loss for 1946, as determined by the Commissioner, was $164,326.38, and we have already disposed of the contention that it should have been increased by $861,118.04, the amount of the excess profits taxes paid by the taxpayer in 1946 in respect of 1945.

The taxpayer contends that in computing the amount of the 1946 net operating loss ($164,326.38) which is to be carried back to 1945, there should first be offset against 1944 net income ($584,866.81) either (a) the sum of $759,916.50, being the amount of the 1943 excess profits taxes reflected in the taxpayer's return for that year and *paid* by it in 1944, or (b) the sum of $625,561.59, being the amount of the 1944 excess profits taxes as reflected in the taxpayer's return for 1944, and which it claims *accrued* in 1944. Since under (a) the 1943 excess profits taxes *paid* in 1944 ($759,916.50) exceeded by $175,049.69 the unadjusted net income for 1944 ($584,866.81) and under (b) the 1944 excess profits taxes *accrued* for that year ($625,561.59) exceeded by $40,694.78 such net income for 1944 ($584,866.81), the taxpayer claims that the entire 1946 net operating loss ($164,326.38) constitutes a "carry-back" to 1945. We cannot agree.

What we have already held as to the meaning of "paid or accrued" in §122(d)(6) in connection with the computation of the 1946 net operating loss equally applies to the §122(d)(6) adjustment to

1944 net income, and disposes of the contention that for this purpose the taxpayer was entitled to deduct from such income the 1943 excess profits taxes *paid* in 1944.

The other contention must also fail. The excess profits taxes ultimately found by the Commissioner to be due in respect of the year 1944 were $280,540.33, and not $625,561.59, as originally reported in the taxpayer's 1944 return, and we think it was this figure rather than the uncorrected figure which represented the measure of the §122(d)(6) adjustment to 1944 net income. Section 122(d)(6) allows the deduction of "the amount" of excess profits taxes "imposed" and (in the case of an accrual taxpayer) "accrued within the taxable year." The tax which was "imposed" for 1944 was $280,540.33, and that in our opinion was "the amount" of the tax which "accrued" in 1944 for purposes of this adjustment. True, it has been held that when all the events necessary to determine the amount of a tax have occurred within a taxable year, the tax as reported in that year constitutes the tax "accrued" despite the occurrence of later events which change the amount of the tax ultimately found due. See *United States* v. *Detroit-Moulding Corp.*, 56 F. Supp. 754 (E. D. Mich. 1944). But if we are to follow this view we should also take the *income* as originally reported in the 1944 return, *viz.*, $827,852.99 instead of $584,866.81 as finally determined by the Commissioner. What the taxpayer is seeking to do is to have the benefit of both the *smaller* 1944 income as finally determined ($584,-

866.81) and the *larger* excess profits tax ($625,561.59), based upon the income as originally reported. The taxpayer must match either the *returned* income ($827,852.99) against the *returned* excess profits tax based thereon ($625,561.59), or the *determined* income ($584,866.81) against the determined excess profits tax ($280,540.33). It cannot have it both ways at the same time by matching *determined* income against *returned* excess profits taxes. And we think it is *determined* income and excess profits taxes that represent the proper §122(d)(6) adjustment, since the manifest purpose of the "carry-back" and "carry-over" provisions of the statute, §122(b)(1), (2) is that the incidence of this kind of taxation upon a business enterprise shall in effect be looked at from the vantage point of a five year period, that is the current taxable year plus two "carry-back" and two "carry-over" taxable years.

In light of this wearisome discussion, we think that the correct situation as to the 1946 "carry-back" was this: The taxpayer's 1944 net income, before the §122(d)(6) and §23(s) adjustments, was $584,866.81. The excess profits taxes which accrued for 1944 were $280,540.33. After the §122(d)(6) adjustment ($584,866.81 *minus* $280,540.33), the balance of 1944 income was $304,326.48. Since this was greater than the net operating loss for 1946 ($164,326.38), this resulted, as the Commissioner and Tax Court determined, in there being nothing left from the 1946 net operating loss to "carry back" to 1945. It likewise resulted in there being taxable income for 1944.

5. Computation of 1945 Excess Profits Tax Deficiency

In computing the excess profits tax deficiency for 1945, the Commissioner apparently gave no credit for the $108,437.36 remitted by the taxpayer on September 29, 1947. The taxpayer asserts this was an amount "collected without assessment" which under §271(a)(1)(B) the Commissioner was required to take into account in computing the 1945 deficiency. See *McConkey* v. *Comm'r*, 199 F. 2d 892 (4th Cir. 1952), *cert. denied* 345 U. S. 924 (1953); *Bendheim* v. *Comm'r*, 2d Cir., decided June 9, 1954.

For the reasons already discussed, we think that this would be so only if the remittance were made under circumstances which would constitute it a satisfaction of a tax liability in whole or in part. In the *McConkey* and *Bendheim* cases, *supra*, the taxpayers made remittances similar to that now under consideration. Each of those remittances was deposited in the Collector's "Suspense Account" and stood, under the authority of the *Rosenman* case, as "a cash bond for the payment of taxes thereafter found to be due," or, in effect, as a continuing offer by the taxpayer to the Collector that he apply the amount to the discharge of a tax liability in whole or in part. And in each of those cases the Collector, after these deposits with their implicit offers had been made, stated a proposed deficiency not in excess of the deposit, thereby indicating unequivocally an acceptance of the taxpayer's offer. Accordingly, the amounts became "col-

lected without assessment" within the meaning of §271(a)(1)(B), and the taxpayer's sole remedy remaining was an independent suit for refund.

Here, however, the Collector did not accept, explicitly or implicitly, the taxpayer's remittance as a discharge of its tax liability, in whole or in part, nor could he be forced to do so while that liability was still in dispute. Indeed, no deficiency had yet been proposed in 1947. But in 1948 the Revenue Agent proposed a deficiency in excess of the taxpayer's remittance, as to which the Commissioner issued his deficiency notice on February 16, 1950, and which the taxpayer was free to, and did, contest; and certainly the Commissioner for his part was not required to circumscribe his position in the ensuing litigation in the Tax Court by making application of such remittance to the asserted tax liability. In other words, until the Commissioner, with unequivocal authority of the taxpayer, applied or was required to apply the $108,437.36 remittance as a satisfaction, in whole or in part, of the asserted tax liability, this remittance did not constitute an amount "collected without assessment" within the meaning of §271, but continued as no more than a deposit voluntarily made by the taxpayer.

Affirmed.

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THE UNITED STATES, PETITIONER

v.

OLYMPIC RADIO AND TELEVISION, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The original opinion of the Court of Claims and the dissenting opinion (R. 10-14) are reported in 108 F. Supp. 109. The opinion on rehearing (R. 16-19) is reported in 110 F. Supp. 600.

JURISDICTION

The judgment of the Court of Claims was entered November 4, 1952. (R. 10, 14.) On December 3, 1952, the Government filed a motion for rehearing (R. 14) which was denied on March 3, 1953 (R. 16).

The petition for a writ of certiorari was filed on May 29, 1953, and was granted on October 14, 1954. (R. 21.) The jurisdiction of this Court rests on 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

Whether, under Section 122(d)(6) of the Internal Revenue Code, a taxpayer on the accrual basis can, in computing its net operating loss for one year, deduct the amount of excess profits taxes which were paid in that year but had accrued in an earlier year.

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory provisions (Sections 23(c)(1) and (s), 41, 43, 48(c), 122, 710(a)(1) and (b), 711(a)(1)(J) and (2)(L) of the Internal Revenue Code of 1939) [1] and Treasury Regulations (Treasury Regulations 111, Sections 29.41-1, 29.41-2, 29.43-1, 29.122-1, and 29.122-2) are set forth in Appendix A, *infra*, pp. 36-53.

STATEMENT

This case was submitted to the Court of Claims on motions for summary judgments filed by both parties, together with supporting affidavits. The facts, which are not in dispute, are as follows:

Taxpayer, a New York corporation, keeps its accounts and files its income and excess profits

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[1] All references to the "Internal Revenue Code" or "Code" are to the "Internal Revenue Code of 1939" unless otherwise expressly noted.

tax returns on the accrual basis, using the calendar year as its accounting period. (R. 1.) It seeks to recover in this action the sum of $148,841.72, representing a portion of the excess profits tax for the year 1944 which it paid in 1945 in the total amount of $623,454.42. (R. 2, 3, 11.)

Taxpayer's income tax return for the year 1946 reflected a net operating loss of $324,844.23 which, upon audit by the Commissioner and with taxpayer's acquiescence, was reduced to $310,872.60. (R. 2.) The net operating loss of $310,872.60 was carried back and set off against taxpayer's excess profits net income for 1944, as permitted by law, and its excess profits tax for 1944 was adjusted in conformity with the resulting reduction in income. (R. 2, 5, 11.) This adjustment is not in controversy.

In the year 1946 taxpayer paid $263,272.80 on account of a reported excess profits tax liability of $346,643.22 for the year 1945. (R. 2, 9.) It contends that under Section 122(d)(6) of the Internal Revenue Code (Appendix A, *infra,* p. 42) the $263,272.80 so paid in 1946 should have been added to the admitted net operating loss of $310,872.60 for that year, and that the sum of these two figures ($574,145.40), instead of the second figure alone, should have been carried back as a net operating loss from 1946 to 1944 (R. 5, 11). If this had been done, the Court of Claims found, it would have further reduced the 1944 excess profits tax liability by $148,841.72, which is the amount claimed in this suit. (R. 11-12.)

Although, as stated above, taxpayer originally reported an excess profits tax liability of $346,643.22 for the year 1945, of which $263,272.80 was paid in 1946, the entire amount of the reported tax was subsequently refunded or credited to taxpayer as a result of a net operating loss carryback from 1947 to 1945. (R. 10.)

The Court of Claims sustained taxpayer's contention and held (Madden, J., with whom Jones, C. J., concurred, dissenting) that, in computing its net operating loss for 1946, taxpayer was entitled to include therein the amount of excess profits tax paid in 1946 on account of the liability shown on its return for the year 1945. (R. 10-14.) Judgment was entered in favor of taxpayer in the amount of $148,841.72 with interest. (R. 14.) On rehearing, the court adhered to its original decision. (R. 16-19.)

SUMMARY OF ARGUMENT

I

A. The applicable statutory definitions require the conclusion that Congress used the alternative verbs "paid or accrued" in Section 122(d)(6) to distinguish between taxpayers on a cash basis and taxpayers on an accrual basis (i. e., "paid," if on cash basis, and "accrued," if on accrual basis), and that a taxpayer has no option to take deductions on a basis inconsistent with the method of accounting which it employs. Thus, Section 48(e) explicitly directs that, when used in "this chapter" (Chapter 1, which includes Section 122), the

"terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed. . ." The same principle is declared in the relevant accounting rules prescribed by the Code (Sections 41, 43) and in pertinent Treasury Regulations. As stated by the Second Circuit in *Lewyt Corp.* v. *Commissioner,* No. 417, there can be no "ignoring the plain mandate of the statute" (215 F. 2d 518, 526). There is particularly strong reason when a taxpayer is seeking the advantage of a deduction—a matter not of right but of legislative grace—that it be required to bring itself clearly within the statute.

In keeping with the above provisions, the courts have held, in a wide variety of situations, that one reporting income on an accrual basis is bound by the rule which requires such a taxpayer to take deductions only in the year of accrual. It is also significant that taxpayer does not suggest a recomputation of the whole of its operations on a cash basis consistent with its claim for taking subsection (d)(6) deductions on a cash basis.

Taxpayer is not aided by *Commissioner* v. *Clarion Oil Co.,* 148 F. 2d 671 (C.A. D.C.), and similar cases involving the imposition of a penalty surtax on the undistributed income of personal holding companies. Those cases hold that while the statutory definitions of "paid or accrued" in terms control the method of computing net income (see 148 F. 2d at 675), they need not be applied in determining the penalty tax on undistributed in-

come prescribed by subchapter A of chapter 2. The net operating loss deduction claimed in the instant case relates solely to the "computing [of] net income" (Section 23(s)) and, under the reasoning of *Clarion Oil*, the statutory definition of "paid or accrued" controls.

Taxpayer also urges a departure from the statutory definition on the ground that otherwise accrual basis taxpayers will get no substantial benefits from Section 122(d)(6). But there are situations in which excess profits taxes will "accrue" during a loss year and will cause or augment a net operating loss. See, *e.g., Robert Reis & Co.* v. *Commissioner*, 20 T.C. 294. And, in any event, the fact that cash basis taxpayers may as a practical matter derive more benefits from this provision than accrual basis taxpayers could not warrant a revision of the statute by the courts. Cf. *Crooks* v. *Harrelson*, 282 U.S. 55, 60.

B. Taxpayer asserts the right to augment its 1946 net operating loss by the amount of excess profits taxes, accrued in 1945, which it paid in 1946. Assuming, *arguendo*, contrary to our contention above, that the statute permits an accrual basis taxpayer to follow such a course, there is a further obstacle to the claimed deduction in the instant case. The amount paid in 1946 was subsequently refunded in full as a result of a carryback from 1947. Thus, no actual economic loss was suffered as a result of the 1946 payments and no net operating loss can be founded upon them. Section 122(d)(6) allows as a deduction the amount of excess profits taxes actually *imposed*

in a given taxable year. There were not two excess profits taxes imposed for 1945; there was only one, and that was in the amount as finally determined.

II

The language of Section 122(d)(6) had its antecedent in Section 23(c)(2) as amended by the Revenue Act of 1941. Examination of the earlier section in its entirety shows that when Congress wished to treat cash basis and accrual basis taxpayers similarly for purposes of a particular deduction, it did so explicitly. Rule "A" of Section 23(c)(2) provided:

> The deduction shall be limited to the tax imposed for the taxable year, but any portion of such tax paid after the taxable year shall be considered as having been paid within the taxable year; * * *

The failure to adopt a similar provision in Section 122(d)(6), added in 1942, supports the view that the words "paid or accrued", as there used, must be taken in their ordinary, statutory sense.

The specific Congressional purpose in adding Section 122(d)(6) is not unequivocally expressed in the legislative history. The underlying legislative policy can be gleaned, however, from the following:

(1) The language of the new subsection had its origin in Section 23(c)(2) as amended by the 1941 Act. In the framework of that Act, a taxpayer deducted its excess profits tax for purposes of computing its other corporate taxes (normal tax and

surtax). When this was altered by the 1942 Act, which authorized a different and larger deduction, and hence a new method of computing the normal tax and surtax, Section 23(c)(2), providing for deduction of excess profits tax, was repealed.

(2) The reappearance of this language in Section 122(d)(6), described as one of a "number of miscellaneous amendments" of a "technical" nature "made necessary by [the] change in base for corporate tax" and required "in order to make it all come out straight," hardly suggests that Congress contemplated a novel and far-reaching deduction of the kind which taxpayer urges—a deduction which would permit a corporation, whether on cash or accrual basis, to deduct all excess profits taxes, both paid and accrued within any taxable year, for purposes of determining its net operating loss.

Since it may be fairly stated that, whatever else was contemplated (or overlooked), there is no evidence of an express or implied intention to effect a drastic departure from familiar and accepted tax concepts, the legislative history, far from supporting the motion that (d)(6) should be construed to obliterate the statutory definition of "paid or accrued," emphasizes the wisdom of confining the amendment within the limits of its statutorily-defined terminology.

ARGUMENT

Section 23(s) of the Internal Revenue Code of 1939 provides that in computing net income there shall be allowed "the net operating loss deduction

computed under section 122" (Appendix A, *infra*, p. 36). The "net operating loss deduction" for a taxable year is based on the "net operating losses" for the two preceding and two succeeding years, which, subject to certain adjustments, become available as "carry-overs" and "carry-backs" to the taxable year.[2] We are here concerned with the amount of the "net operating loss" for the year 1946 which may be carried back to the year 1944. Section 122(a) of the Code defines the term "net operating loss" to mean "the excess of the deductions allowed by this chapter [Income Tax] over the gross income, with the exceptions, additions, and limitations provided in subsection (d)." (Appendix A, *infra*, p. 38.) Section 122(d)(6) provides that "There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 [Excess Profits Tax] paid or accrued within the taxable year." (Appendix A, *infra*, p. 42.)[3]

The years 1944 and 1945 were years of profit for taxpayer, and were followed by years of loss

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[2] Determination of the net operating loss under Section 122 (a) is the first of the three steps involved in computation of the net operating loss deduction. The second involves determination of the amount and extent to which the net operating loss may be utilized as a two-year carry-back or carry-over, as set out in Section 122(b) (Appendix A, *infra*, pp. 38-40). The third step is conversion of the aggregate of permissible carry-overs and carry-backs under Section 122(c) (Appendix A, *infra*, pp. 40-41) into the net operating loss deduction. *Reo Motors* v. *Commissioner*, 338 U.S. 442, 446-447; Treasury Regulations 111, Section 29.122-1 (Appendix A, *infra*, pp. 49-50).

[3] This provision is subject to certain rules not here relevant.

in 1946 and 1947. (Statement, *supra*, pp. 3-4.) The court below (two judges dissenting) held that although taxpayer admittedly maintained its books and records and filed its tax returns on the accrual basis of accounting, and although its 1945 excess profits tax accordingly *accrued* in 1945, taxpayer might nonetheless, under Section 122(d)(6), augment its net operating loss for 1946 by including the sum of $263,272.80 *paid* in 1946 on account of its excess profits tax liability for 1945. (R. 11-14.) In reaching this result, which is diametrically opposed to the holding of the Court of Appeals for the Second Circuit in the companion case of *Lewyt Corp.* v. *Commissioner*, No. 417, this Term (see 215 F. 2d 518, 523-526, affirming the unanimous decision of the full Tax Court, 18 T.C. 1245), the majority of the court of claims conceded that its decision "does violence to the letter of the Act" but was of the view that the result was in keeping with the purpose of Congress. (R. 13.)[4]

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[4] The majority below noted its disagreement and the minority its concurrence with the Tax Court's decision in the *Lewyt* case. (R. 14.) Since the decision below, the Tax Court has repeatedly expressed adherence to its decision in *Lewyt*. *Hunter Manufacturing Corp.* v. *Commissioner*, 21 T.C. 424, appeal pending (C.A. 3d); *Wheeler Insulated Wire Co.* v. *Commissioner*, 22 T.C. 380, appeal pending (C.A. 2d); *W. L. Maxson Corp.* v. *Commissioner*, decided January 26, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,021), supplemental opinion June 17, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,174), appeal pending (C.A. 2d); *Byrne Doors, Inc.* v. *Commissioner*, decided April 8, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,107), appeal pending (C.A. 6th).

It is the Government's position that in the light of the unambiguous provisions of the Internal Revenue Code, which are discussed in Point I, *infra*, it was not open to the court below to speculate concerning the possible purposes contemplated by Congress and to create opportunities for extensive deductions in circumstances where they are explicitly precluded by the statutory language. We shall urge additionally (Point II, *infra*) that the legislative history does not support the Court of Claims' position, but fairly indicates that Congress did not intend to change the meaning of "paid or accrued" explicitly defined in Chapter 1 of the Code.

I

The Explicit Mandate of the Statute Precludes Allowance of the Deduction for Which Taxpayer Contends

A. *Section 122(d)(6) denies an accrual basis taxpayer the right to deduct its excess profits tax in the year paid, if the tax accrued in another year.*

1. As stated above, Section 122(d)(6) permits deduction of the amount of excess profits tax "paid or accrued" in the taxable year. In our view, definitive provisions of the Internal Revenue Code, as well as implementing Treasury Regulations of long standing, require the conclusion that the alternative verbs "paid or accrued" serve to distinguish between taxpayers on a cash basis and taxpayers on an accrual basis (i.e., "paid," if on a cash basis, and "accrued," if on an accrual

basis) and do not provide the taxpayer an option to take deductions on a basis inconsistent with the method of accounting which it employs.

Section 41 (Appendix A, *infra*, p. 37) states the general rule that "net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer * * *."

Section 43, entitled "Period for Which Deductions and Credits Taken," provides (Appendix A, *infra*, pp. 37-38):

> The deductions and credits * * * provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

Even more pointedly, Section 48(c) specifically provides (Appendix A, *infra*, p. 38) that, when used in "this chapter" (i.e., Chapter 1, entitled "Income Tax," which *includes* Section 122)—

> The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed * * *.[5]

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[5] This language has been substantially incorporated in income tax legislation commencing with the Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 200.

Treasury Regulations 111, Section 29.41-2 (Appendix A, *infra*, pp. 47-48), referring to the definition in Section 48, declares that "A method of accounting will not * * * be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency." And Section 29.43-1(a) of the Regulations (Appendix A, *infra*, pp. 48-49) states:

> The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).)

The above provisions are unequivocal. As stated by the court of appeals in the companion *Lewyt* case, No. 417, no argument rested on claim of hardship or legislative history which might be advanced in favor of a different result could justify "ignoring the plain mandate of the statute" (215 F. 2d at 526). To similar effect, see *Healy* v. *Commissioner*, 345 U.S. 278, 284-285; *Riley Co.* v. *Commissioner*, 311 U.S. 55, 59; *Crooks* v. *Harrelson*, 282 U.S. 55, 60; *United States* v. *Hill*, 248 U.S. 420. There is particularly strong reason when a taxpayer is seeking the advantage of a deduction—a matter not of right but of legislative grace—that it be required to bring itself clearly within the statutory provision. *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330, 333-334 (C.A. 10th); see also *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440; *White* v. *United States*, 305 U.S. 281, 292; *Deputy* v. *duPont*, 308 U.S. 488, 493.

2. In keeping with the statutory provisions discussed above, the courts have held, in a wide variety of situations, that one reporting income on an accrual basis may not evade the rule which requires such a taxpayer to take deductions in the year of accrual. See, *e.g.*, this Court's decisions in *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Aluminum Castings Co.* v. *Routzahn*, 282 U.S. 92; *Niles Bement Pond Co.* v. *United States*, 281 U.S. 357; *United States* v. *Anderson*, 269 U.S. 422.[5a]

This Court's decision in *Reo Motors* v. *Commissioner*, 338 U.S. 442, is also closely in point, for there, as here, the taxpayer contended that language in Section 122 should bear a special interpretation different from the meaning accorded the same terms when used in other parts of Chapter 1. Rejecting this contention, the Court declared (p. 448):

> If, as petitioner contends, 1942 law governs although the loss occurred in 1941, it is difficult to see why the whole of its 1941 operations, and not merely the Reo Sales liquidation, should not be recomputed on the basis of the income and deduction provisions applicable in 1942. Petitioner does not suggest such a re-

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[5a] It is to be noted that Section 23, which provides (subsection (s)) that in computing net income there shall be allowed "the net operating loss deduction computed under section 122," uses the words "paid or incurred" and "paid or accrued" in various subsections (subsections (a)(1) and (2) (expenses); (b) (interest); (p) (pension trust); (z)(1) (taxes and interest paid to cooperative apartments)). And see especially Section 23 (c) (1), relating to deduction of taxes (Appendix A, *infra*, p. 36). There appear to be no cases arising under these subsections in which the courts have treated the quoted words in any sense other than that specified by

> computation, in spite of the fact that *the terms in which net operating loss is defined—"gross income" and "deductions allowed by this chapter"—are equally applicable in the computation of income taxes generally.* [Emphasis added.]

Nor does the taxpayer in the instant case suggest a recomputation of the tax for the whole of its operations for the pertinent years on a cash basis consistent with its claim for taking subsection (d)(6) deductions on a cash basis. Indeed, with the exception of the term "paid or accrued," taxpayer does not suggest that any of the numerous terms contained in Section 122 [6] should be interpreted differently for purposes of that section from the way in which they are understood throughout Chapter 1. [7] Yet, as observed above, it is explicitly directed in

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Section 48(c). See Mertens' comment (5 Mertens, *Law of Federal Income Taxation* (1953 ed.), Section 27.52), in relation to Section 23 (c)(1), that taxes are deductible "in the year of payment, and only in that year, by taxpayers on a cash basis and in the year of accrual, and only in that year, by taxpayers on an accrual basis."

[6] Examples of such terms, with which Section 122 is replete, are: "deductions allowed by this chapter," "gross income," "taxable year," "net income," "normal-tax net income," "discovery value," and in 122(d), in particular, "depletion," "percentage depletion," "interest paid or accrued," "capital assets," "operation of a trade or business," "consolidated return."

[7] It may be noted that the House Committee which originally recommended the enactment of Section 122 in the 1939 Act assumed that the definitions contained in Section 48 would be applicable to Section 122. Thus, referring to the term "taxable year" used in Section 122(b), the Committee stated (H. Rep. 855, 76th Cong., 1st Sess., p. 17 (1939-2 Cum. Bull., p. 517)):

> For the purpose of ascertaining the first, second, or third preceding taxable year, a fractional part of a year which

Section 48(c) that the term " 'paid or accrued' shall be construed" according to taxpayer's method of accounting.

The line of cases upon which the majority below relied (R. 13) is clearly distinguishable.[8] Those cases involved provisions of the Code imposing a penalty surtax on the undistributed profits of personal holding companies. In computing the amount of undistributed profits, Section 505(a) permitted, *inter alia*, the deduction of excess profits taxes "paid or accrued during the taxable year." The cases in question hold that for purposes of these penalty provisions, which are incorporated in the personal holding company surtax provisions of Sections 500 *et seq.*, Chapter 2, the definitions of "paid or accrued" contained in Chapter 1 (see Sections 43 and 48(c), discussed *supra*, pp. 12-13) need not be deemed controlling. Thus, speaking of Section 48(c), the court stated in the *Clarion Oil* case (148 F. 2d, p. 675):

> But, obviously, this definition was intended to apply to the method of computing *net income*, and has no reference or relevancy to the subject matter of what, for the purposes of the

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is a taxable year under section 48(a), is a preceding taxable year.

The governing regulation (Treasury Regulations 111, Section 29.122-1) makes the same reference.

[8] *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C.A. D.C.), certiorari denied, 325 U.S. 881; *Aramo-Stiftung* v. *Commissioner*, 172 F. 2d 896 (C.A. 2d); *Birmingham* v. *Loetscher Co.*, 188 F. 2d 78 (C.A. 8th); *Wm. J. Lemp Brewing Co.* v. *Commissioner*, 18 T.C. 586, 600-601, acquiesced in by the Commissioner, 1952-2 Cum. Bull. 2. The recent decision in *Harry M. Stevens, Inc.* v. *Johnson*, 115 F. Supp. 310 (S.D.

> newly added provision in relation to personal holding companies, is taxable as *undistributed* income.

However, under Section 23(s), here involved, "the net operating loss deduction computed under section 122" is deductible "*in computing net income.*" (Emphasis added.) Under the very reasoning of *Clarion Oil*, therefore, Chapter 1 definitions of "paid or accrued" control. To restate the point in the language of the court of appeals in the *Lewyt* case (215 F. 2d, p. 525):

> The Clarion and the other cases cited are inapplicable to the one before us. Here the meaning of "paid or accrued" in § 122(d)(6) is directly involved in the computation of *net income*, for § 23(s) allows as a deduction in "computing net income" under § 23 "the net operating loss deduction computed under section 122." In addition, to the extent that the meaning of "paid or accrued" is involved in the computation of the net operating loss itself by application of the § 122(d)(6) deduction, § 43 specifically gives it the same meaning as § 48(e) requires in connection with the computation of net income.

See, also, dissenting opinion of Judge Madden below. (R. 14.)

3. Respondent argues that the Government's construction should not be adopted because it would

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N.Y.), pending on appeal (C.A. 2d), involving surtax under Section 102 on corporations improperly accumulating surplus, is distinguishable on like grounds.

work an inequitable result. The contention is that while such a construction extends substantial benefits to a cash basis taxpayer, "it is almost impossible as a practical matter for an accrual basis taxpayer to incur a net operating loss under Chapter 1 * * * and in the same year incur an excess profits tax liability under Chapter 2E * * *." (Br. in Op. 11.)

We would point out, to begin with, that there are situations in which the statutory provision, as we construe it, will result in benefit to an accrual basis taxpayer. For example, an accrual basis taxpayer may derive benefit from Section 122(d)(6) if excess profits taxes for a given year are disputed and not settled until a later year.[9] Under the rule established by *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516, the disputed tax liability accrues in the year of settlement, which might, of course, be a loss year. It then becomes part of the net operating loss for that year. That was the precise situation before the Tax Court in *Robert Reis & Co.* v. *Commissioner,* 20 T.C. 294, 298-299, in which the court commented:

> In passing, we note that our holding refutes a contention made by the taxpayer in the *Lewyt* case. There it was argued that to construe "paid or accrued" as used in section 122(d)(6) as referring to the accounting system used by the taxpayer would deny ac-

[9] Originally, taxpayer claimed not only the 1945 tax paid in 1946 but also certain other taxes which accrued in 1946 as the result of a settlement in that year of disputed taxes for an earlier year. However, it subsequently abandoned its claim as to the accrued taxes (R. 5, 7.)

> crual basis taxpayers any benefit under the section. We point out that the accrual taxpayer here does get a benefit.

See, also, the court of appeals opinion in *Lewyt*, 215 F. 2d at 526.

Another instance is that of an accrual basis taxpayer which, having derived abnormal income during a given taxable period, allocated part of that income, for excess profits tax purposes, to a later tax year, as authorized by Code Section 721. The later year could, of course, be a loss year.[10]

More broadly, we would emphasize that innumerable individual provisions in the complex structure of the tax laws will have a differing incidence depending on the method of accounting utilized by the taxpayer. Thus, in 1940, when the excess profits tax took effect, the cash basis taxpayer was obliged to pay the tax on goods or services sold and delivered in 1939 for which payment was received in 1940. In the case of the accrual basis taxpayer, identical transactions were free from excess profits taxation. This example might be multiplied many times over. Such results will inevitably occur unless Congress should require all taxpayers to employ the same system of accounting for tax purposes. The underlying assumption upon which the tax laws operate is that when a taxpayer adopts a method of accounting (a taxpayer whose transactions are many and complicated usually finds the accrual method more desirable be-

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[10] Example 3, Appendix B, *infra*, p. 55, illustrates such a case.

cause expenses are more likely to be deducted in the year in which the income to which they relate is reported), the disadvantages which attach to that method will not, over the long run, outweigh the advantages. In substance, Congress has said to the taxpayer: You may exercise the option to keep your books on a cash basis or an accrual basis; but you may not compute your income and your deductions on one basis for purposes of one provision of the income tax laws and on another basis for purposes of another provision of those laws.

In rejecting arguments similar to those made by respondent, based upon alleged hardships to individual taxpayers or classes of taxpayers, this Court stated (*Crooks* v. *Harrelson*, 282 U.S. 55, 60):

> It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts.

See also *Taft* v. *Commissioner*, 304 U.S. 351, 358-359; *Pillsbury* v. *United Eng. Co.*, 342 U.S. 197, 199-200.

B. *In any event, a deduction under Section 122(d)(6) must reflect an excess profits tax actually imposed. Taxpayer's claim here lacks this foundation*

We have argued above that taxpayer could not add its 1945 excess profits tax, paid in 1946, to its 1946 net operating loss because, as an accrual basis taxpayer, its tax accrued in 1945. Assuming, *arguendo,* however, that taxpayer could hurdle this obstacle, there is a further barrier to allowance of taxpayer's claim.

As pointed out in the Statement (*supra,* p. 4), the 1945 excess profits tax paid by taxpayer was subsequently refunded or credited in full as a result of a net operating loss carry-back from 1947. Thus, the 1945 excess profits tax liability was wiped out. And since no economic loss was suffered, the foundation upon which taxpayer seeks to augment its 1946 net operating loss is destroyed.

We would emphasize that Section 122(d)(6) allows as a deduction "the amount of [excess profits] tax *imposed* . . ." (emphasis added). A sum which was paid in the loss year, but was subsequently refunded, does not represent an amount of tax actually imposed. Certainly, there were not two amounts imposed for 1945; there was only one, and that one was the amount which finally became determinable after application of the 1947 carry-back.

Essentially the same question (though arising in a somewhat different context) is before this Court

in *Lewyt*, No. 417. As Judge Harlan stated for the court of appeals in that case, "The excess profits taxes ultimately found by the Commissioner to be due in respect of the year 1944 . . . rather than the uncorrected figure . . ." constituted "'the amount' of excess profits taxes 'imposed'" within the meaning of Section 122(d)(6). Application of this principle to the case at bar would require reversal of the Court of Claims' judgment here, entirely apart from the issue discussed in Point IA, *supra*.[10a]

II

The Legislative History Furnishes No Basis for a Departure from the Statutory Language

The discussion of the legislative history which follows is addressed to two questions: (a) Whether there is anything in the legislative antecedents and history of Section 122(d)(6) to show that the phrase "paid or accrued" used in that section was meant to have a meaning varying from the statutory definition of the term; and (b) whether the entire statutory scheme and history show that Congress proposed to extend to accrual basis taxpayers, through the deduction of excess profits taxes, benefits in addition to those which could be accorded them under the prevailing definitions of the statute.

A. The court below did not discuss taxpayer's argument, renewed in the brief in opposition to certiorari (pp. 7-9), based upon the legislative ante-

[10a] For a fuller discussion of this principle, we respectfully refer the Court to the Government's brief in No. 417.

cedents and history of Section 122(d)(6)—a failure which suggests that it found no support there for its conclusion. In the *Lewyt* case, the taxpayer advanced a similar argument, both in the Tax Court and in the court of appeals. Those courts found that the history of Section 122(d)(6) and its antecedents was inconclusive and provided no warrant for rejecting the statutory definition of "paid or accrued." See 18 T.C. at 1251-1252; 215 F. 2d at 524-525.

The committee reports, themselves, are silent in respect to the meaning of "paid or accrued" as used in Section 122(d)(6), and taxpayer's argument rests upon inferences which it seeks to draw from the omission of language used in a different context in an earlier year. That argument (summarized by the Second Circuit in *Lewyt*, 215 F. 2d at 524), is as follows:

Section 202(a) of the Revenue Act of 1941 amended Section 23(c) of the Internal Revenue Code to permit deduction of Chapter 2E excess profits taxes "paid or accrued within the taxable year" in computing net income, subject to certain rules provided in Section 23(c)(2).[11] The following year, the Revenue Act of 1942, c. 619, 56 Stat. 798, eliminated Chapter 2E excess profits taxes as

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[11] (2) *Excess-Profits Tax Under Chapter 2E—Special Rules.*—For the purposes of this subsection, in the case of the excess-profits tax imposed by Subchapter E of Chapter 2—

(A) The deduction shall be limited to the tax imposed for the taxable year, but any portion of such tax paid after the taxable year shall be considered as having been paid within the taxable year;

(B) No reduction in such tax shall be made by reason

a deduction in computing net income, but added a new section (Section 122(d)(6)) permitting the deduction of such excess profits taxes from gross income in computing the net operating loss, and net operating loss "carry-backs" and "carry-overs."[12] This was subject to rules substantially the same as those formerly contained in Section 23(c)(2), as amended by the Revenue Act of 1941, except that rule "A" of that section, quoted above (note 11), was omitted.

Pointing out that the effect of rule "A" in Section 23(c)(2) was to place a cash basis taxpayer substantially on the accrual basis so far as the excess profits tax deduction was concerned, taxpayer argues that the omission of that rule in Section 122(d)(6) suggests that Congress did not intend to place all taxpayers on the accrual basis. Accepting this inference, however, it certainly does not follow that Congress meant to give either class of taxpayers (accrual basis or cash basis) an election to deduct its excess profits taxes on a basis inconsistent with the method of accounting to which that class was committed.

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of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

(C) Such tax shall be computed without regard to the adjustments provided in section 734; and

(D) Such tax, in the case of a consolidated return under section 730, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

[12] The elimination and the addition were accomplished by Sections 105(c) and 105(c)(3)(C) of the 1942 Act, respectively.

Indeed, this phase of the legislative history tends to support the Government's position that Congress used "paid or accrued," in Section 122(d)(6), in its customary, statutorily-defined sense. Rule "A" of Section 23(c)(2), as added by the 1941 Act, appeared in a section allowing the deduction of taxes "paid or accrued." It cannot be denied that the phrase "paid or accrued" was there used as a term of art, i.e., in its long-accepted, statutory sense. The professed purpose of Congress in the enactment of Rule "A" was to place all taxpayers, cash and accrual, on the same basis in respect to the deduction for excess profits taxes.[13] Congress did so, however, not by giving a right of election or by stating that a cash basis taxpayer might deduct "accrued" taxes; it expressly provided that any portion of such tax "paid" after the taxable year "shall be considered as having been paid within the taxable year."[14] The manner

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[13] H. Rep. No. 1040, 77th Cong., 1st Sess., p. 46 (1941-2 Cum. Bull. 413, 450); S. Rep. No. 673 (Part 1), 77th Cong., 1st Sess., p. 37 (1941-2 Cum. Bull. 466, 495-496):

> It is provided that the deduction shall be allowed only in computing the income tax imposed for the taxable year for which the excess-profits tax is levied. By providing that any excess-profits tax paid after the taxable year shall be deemed to have been paid within the taxable year, the same treatment is accorded to taxpayers on the cash basis as is accorded to taxpayers on the accrual basis.

[14] Contrast Code Section 131(d), dealing with the credit for foreign taxes, which provides, subject to certain conditions, that the credits may, "at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books," be taken in the year in which the taxes of the foreign country "accrued."

of effecting, for this purpose, similarity of treatment of cash and accrual basis taxpayers reflects a recognition of the settled meaning of "paid or accrued." The inferences to be drawn from the enactment of Rule "A" of Section 23(c)(2), therefore, are: (1) That Congress was aware of its own statutory definition of "paid or accrued," and (2) that when Congress desired to have cash and accrual basis taxpayers treated alike for certain purposes it knew how to accomplish its purpose. Accordingly, the omission of Rule "A" in the enactment of Section 122(d)(6) in 1942 may reasonably be taken as a continued recognition by Congress of the statutory meaning of "paid or accrued" and as evidence of a Congressional purpose limited to withdrawal of the presumption contained in Rule "A", i.e., the presumption that all excess profits taxes paid by a cash basis taxpayer were paid within the taxable year to which they pertained though in fact paid after the taxable year.

B. As pointed out above, under the 1941 Act the amount of the excess profits tax constituted a deduction for purposes of computation of the normal tax and surtax. This deduction was expressly eliminated under the Revenue Act of 1942 when a larger deduction was allowed in its place. The taxpayer, in computing the normal tax and surtax, is authorized by the 1942 Act to use as a credit the base upon which the excess profits tax is computed, i.e., the amount of the adjusted excess profits net

income.[15] Having thus allowed the base upon which the excess profits tax is computed as a credit, the further allowance of the tax itself as a deduction or credit grants *pro tanto* the same benefit twice over. There is no suggestion that such a double benefit is available to taxpayers with stable profits year in and year out. Yet the underlying purpose in the enactment of the net operating loss deduction was to avoid tax discrimination against businesses with alternating or fluctuating profit and loss years in favor of those with stable profits year in and year out.[16] Certainly, it was not to create a tax advantage in favor of the former; nor is it to be supposed that Congress, without saying that it was doing so, intentionally granted to taxpayers with fluctuating profits double benefits denied to taxpayers generally.

This conclusion is fortified by the fact that the 1942 Act was a war revenue measure notable for its increases in corporate income and excess profits taxes.[17] In the context of such a bill, it is particularly difficult to give credence to the notion that Congress proposed, in an incidental fashion and

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[15] Examples 1 and 2 (Appendix B, *infra*, pp. ~~53-54~~ 54-55) illustrate the differences in computation of the corporate income and excess profits tax between the years 1941 and 1942 resulting from this change of base accomplished by the 1942 Act.

[16] H. Rep. No. 855, 76th Cong., 1st Sess., pp. 9-10 (1939-2 Cum. Bull. 504, 510-511) which recommended the addition of Sections 23(s) and 122 to the Code by enactment of Section 211 of the Revenue Act of 1939, c. 247, 53 Stat. 862.

[17] Compare, *e.g.*, rates shown in Examples 1 and 2 (Appendix, B, *infra*, pp. ~~53-54~~ 54-55).

by an amendment which, as we show below, it characterized as "technical," to legislate a novel deduction authorizing the cancellation or refund of huge amounts of taxes.

The change effected by the 1942 Act in respect to the base for computation of corporate taxes was described in the pertinent Ways and Means Committee Report as follows (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 18 (1942-2 Cum. Bull. 372, 388):

> 1. Change in the Base for Corporate Tax
>
> Under the present law, the excess-profits tax is computed before the normal tax and surtax, being allowed as a deduction in determining the bases to which those taxes apply. Thus, the portion of the adjusted excess-profits net income not taken by the excess-profits tax is subjected to the normal tax and surtax.
>
> The bill changes this method of determining the tax base by dividing the net income into two portions, one of which is subject to excess-profits tax alone, and the other of which is subject only to normal tax and surtax. Instead of deducting the excess-profits tax itself in determining the normal and surtax bases, the bill deducts, through the form of a credit against net income, the adjusted excess-profits net income, the base upon which the excess-profits tax is computed.

This fundamental change was carried out by Section 105(a), (b) and (d) of the 1942 Act. Since the adjusted excess profits net income (and not the ex-

cess profits tax) was thereafter to be deducted in determining corporate normal and surtax bases. Section 105(c) repealed Section 23(c)(2) of the Code (note 11, *supra*, pp. 23-24), as originally added by the 1941 Act, and amended Section 23(c)(1)(B) by including excess profits taxes among those denied deduction (Appendix A, *infra*, p. 36).

Subsection (c) of Section 105, entitled "Technical Amendments Made Necessary by Change in Base for Corporate Tax," in its subparagraph (3) [18] amended Section 122 of the Code by adding,

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[18] (3) *Computation of net operating loss deduction.*—Section 122 (relating to net operating loss) is amended as follows:

(A) Subsection (a) is amended to read as follows:

"(a) *Definition of Net Operating Loss.*—As used in this section, the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d)."

(B) Subsection (c) is amended by striking out the parenthesis at the end thereof and inserting in lieu thereof the following: "and without the credit provided in section 26(c)".

(C) Subsection (d) is amended by striking out "exceptions and limitations" and inserting in lieu thereof "exceptions, additions, and limitations" and by inserting at the end thereof the following new paragraph:

"(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 paid or accrued within the taxable year, subject to the following rules—

"(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

"(B) Such tax shall be computed without regard to the adjustments provided in section 734; and

"(C) Such tax, in the case of a consolidated return

inter alia, the (d) (6) provision here in question. Considered in context, it seems evident that Congress contemplated no major enlargement in the allowance of deductions in general or in the net operating loss deduction in particular. Indeed, in the language of the subsection's title, it contemplated only a "Technical Amendment [s] Made Necessary by Change in Base for Corporate Tax" in the "Computation of net operating loss deduction." This thought was expressed by John O'Brien, Office of Legislative Counsel, House of Representatives, who was called upon at the outset of the Senate hearings on the 1942 bill to explain the changes made by the House in the existing law (Senate Hearings before the Committee on Finance on H. R. 7378, 77th Cong., 2d Sess., p. 34). With respect to the language here under consideration, he stated (p. 41):

> Now, the rest of the amendments in this section are purely technical amendments relating to getting rid of the deduction for excess-profits tax which is in the present law, and various other amendments particularly in connection with the net operating loss, in order to make them come out right. You see, when you change the basis of corporate tax it involves any number of miscellaneous amend-

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for excess-profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary."

ments throughout in order to make it all come out straight.

As shown by their reports,[19] the committees of

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[19] S. Rep. No. 1631, 77th Cong. 2d Sess. pp. 66-67 (1942-2 Cum. Bull., pp. 504, 556):

> The amendments made by this section of the bill, which corresponds to section 105 of the House bill, change both the base and the rates of the corporation income tax. The change in base is made in lieu of the deduction now granted with respect to the excess profits tax imposed by chapter 2E. Section 13(a)(2) of the Code is amended to allow the amount of the adjusted excess profits net income as a credit in computing normal tax net income. This credit, as specified in section 26(e) as amended, is likewise provided under section 15(a) in determining the amount of surtax net income.
>
> * * * * *
>
> Section 23(c)(1) of the Code is amended by this section of the bill to deny the deduction for excess profits taxes paid or accrued for those years in which a credit is allowed under section 26(e).
>
> This section makes *other technical amendments required as a result of the change in the base* of the corporation tax. * * * Section 122 of the Code, relating to computation of the net operating loss deduction allowed by section 23(s) of the Code, is amended so as to allow the excess profits tax paid or accrued within taxable years (subject to certain rules) as a deduction in computing net operating loss for, and net operating loss carry-over and carry-back from, such taxable years. [Emphasis added.]

The House Report was substantially the same except that it employs language appropriate only to carry-overs, since carry-backs were first introduced in the Senate bill. Hence, instead of the last paragraph of the Senate Report, the House Report (H. Rep. No. 2333, *supra*, p. 65 (1942-2 Cum. Bull., *supra*, p. 423) reads as follows:

> This section makes other technical amendments required as a result of the change in the base of the corporation tax. * * * Section 122 of the Code, relating to computation of the net operating loss deduction allowed by section 23(s) of the Code, is amended so as to allow the excess

both Houses plainly accepted this view of the limited extent of the change involved.[20]

It would not be accurate to state that the under-

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profits tax paid or accrued within preceding taxable years (subject to certain rules) as a deduction in computing net operating loss for, and net operating loss carry-over from, such preceding taxable years.

A leading commentator has stated with respect to subsection (d)(6) that "The purpose of this provision is a matter of conjecture and Congressional committee reports and other availal le data are of no assistance on the question of intent," 5 Mertens, *Law of Federal Income Taxation* (1953 ed.), Section 29.02, p. 364. Certainly, there is no suggestion that Congress contemplated the far-reaching consequences which would flow from taxpayer's contention that the language of (d)(6) ("paid or accrued") is to be read in a special sense.

[20] There is a further indication that the (d)(6) amendment was not meant to have more than limited scope. Senator George of the Finance Committee introduced on the floor of the Senate a new amendment to be inserted at the proper place in the bill, "intended to eliminate duplications in the section as it was written, and to clarify certain provisions of the section." 88 Cong. Record, Part 6, p. 8015. The amendment became Section 210 of the Revenue Act of 1942, adding a new subparagraph (J) to Section 711(a)(1) of the Code and a new subparagraph (L) to Section 711(a)(2) (Appendix A, *infra*, pp. 44-46). These new subparagraphs provide, as an adjustment to normal tax net income in arriving at excess profits net income, that in computing the net operating loss for any taxable year under Section 122(a) "no deduction shall be allowed for any excess profits tax imposed by this subchapter." The court below (R. 16-19) did not doubt that these provisions preclude the deduction of excess profits taxes paid or accrued in determining a net operating loss to be carried back for excess profits tax purposes, if the excess profits tax is computed upon excess profits net income under Section 710(a)(1)(A). (Appendix A, *infra*, p. 43). The court, however, thought that if the excess profits tax is computed under Section 710(a)(1)(B) (Appendix A, *infra*, pp. 43-44) the tax is not based on excess profits net income, and hence it held that the limitation imposed by subparagraph (J) of Section 711(a)(1) and subparagraph (L) of Section 711(a)(2) is not applicable.

lying Congressional purpose in adding Section 122-(d)(6) is plainly expressed in the legislative history. See Mertens' comment, note 19, *supra*, p. 32. But, to recapitulate, what does emerge from the legislative history is the following:

(1) The language of the new subsection had its origin in Section 23(c)(2) as amended by the 1941 Act. In the framework of that Act, a taxpayer deducted its excess profits tax for purposes of computing its other corporate taxes (normal tax and surtax). When this was altered by the 1942 Act, which authorized a different and larger deduction, and hence a new method of computing the normal tax and surtax, Section 23(c)(2) providing for deduction of excess profits tax was repealed.

(2) The reappearance of this language in Section 122(d)(6), described as one of a "number of miscellaneous amendments" of a "technical" nature "made necessary by [the] change in base for corporate tax" and required "in order to make it all come out straight" (see *supra*, pp. 29-31), hardly suggests that Congress contemplated a novel and far-reaching deduction of the kind which taxpayer urges—a deduction which would permit a corporation, whether on cash or accrual basis, to deduct all excess profits taxes, both paid and accrued within any taxable year, for purposes of determining its net operating loss.

Since it may be fairly stated that, whatever else was contemplated (or overlooked), there is no evidence of an express or implied intention to work a

major change, the legislative history, far from supporting the view that (d)(6) should be construed without regard to the statutory definition of "paid or accrued," emphasizes the wisdom of confining the amendment within the limits of its statutorily-defined terminology.[21] The Court of Claims thus erred we believe, in concluding that it was justified in doing "violence to the letter of the Act." (R. 13.)

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[21] The court below adopted precisely the contrary approach. It refused to apply the phrase "paid or accrued" as used in Section 122(d)(6) with its established meaning and thus extended the operation of the section to cases not embraced within that meaning. On the other hand, it read Section 710(a)(1)(B) with literalness in order to give indirectly to the taxpayer here benefits expressly denied directly to taxpayer by Section 711(a)(1)(J) and 711(a)(2)(L). See note 20, *supra*, p. 32. The court further ignored the fact that a net operating loss carry-back from 1947 to 1945 resulted in a refund to taxpayer of the entire 1945 excess profits tax paid in 1946; yet, at the same time, it has here permitted the payment of the same 1945 excess profits tax in 1946 to be carried back as a net operating loss to 1944. Inconsistently with its refusal to consider the effect of the 1947 carryback, it has then employed the reduced 1944 corporation surtax resulting from the 1946 carry-back as constituting the base for computing the limit under Section 710(a)(1)(B) of the excess profits tax which might properly be imposed for 1944. These certainly are results never contemplated by Congress.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Claims should be reversed.

Respectfully submitted,

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JANUARY, 1955

APPENDIX A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(c) [As amended by Sec. 202(a) of the Revenue Act of 1941, c. 412, 55 Stat. 687] *Taxes Generally.*—

(1) *Allowance in General.*—Taxes paid or accrued within the taxable year, except—

(A) Federal income taxes;

(B) [As amended by Sec. 105 (c) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] war-profits and excess-profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, section 702 of the Revenue Act of 1934, or Subchapter E of Chapter 2, or by any such provisions as amended or supplemented;

* * * * *

(s) [As added by Sec. 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * *

(26 U. S. C. 1952 ed. Sec. 23.)

PART IV—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

SEC. 41—GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1952 ed., Sec. 41.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred" dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deduc-

tions or credits should be taken as of a different period. * * *

(26 U. S. C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this chapter—

* * * * *

(c) *"Paid or Incurred," "Paid or Accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U. S. C. 1952 ed., Sec. 48.)

SEC. 122. [As added by Sec. 211 (b) of the Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTION.

(a) [As amended by Sec. 105 (e) (3) (A) of the Revenue Act of 1942, *supra*]. *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [As amended by Sec. 153(a) of the Revenue Act of 1942, *supra*]. *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss

deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

(e) [As amended by Secs. 105(e) (3) (B) and 153(b) of the Revenue Act of 1942, *supra*] *Amount of Net Operating Loss Deduction.*— The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (com-

puted without such deduction and without the credit provided in section 26(e));

(d) [As amended by Sec. 105(e) (3) (C) of the Revenue Act of 1942, *supra*] *Exceptions, Additions, and Limitations.*—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) [As amended by Sec. 150(e) of the Revenue Act of 1942, *supra*] Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117(b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains;

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection.

(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 paid or accrued within the taxable year, subject to the following rules—

(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

(B) Such tax shall be computed without regard to the adjustments provided in section 734; and

(C) Such tax, in the case of a consolidated return for excess-profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

* * * * *

(26 U. S. C. 1952 ed., Sec. 122.)

SEC. 710 [as added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]. IMPOSITION OF TAX.

(a) [as amended by Sec. 201 of the Revenue Act of 1941, *supra*] *Imposition.*—

(1) [as amended by Sec. 202 of the Revenue Act of 1942, *supra*] *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) [as amended by Sec. 202 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] 95 per centum of the adjusted excess profits net income, or

(B) [as amended by Sec. 202(b) of the Revenue Act of 1943, *supra*] an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter), and without regard to 80 per centum of

the credit provided in section 26 (h) (relating to credit for dividends paid on certain preferred stock).

* * * * *

(b) *Definition of Adjusted Excess Profits Net Income.* As used in this section, the term "adjusted excess profits net income" in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

(1) [as amended by Sec. 204 of the Revenue Act of 1943, *supra*] *Specific exemption.*—A specific exemption of $10,000;

(2) *Excess profits credit.*—The amount of the excess profits credit allowed under section 712; and

(3) [as amended by Sec. 2 (a) of the Excess-Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and Sec. 204 (a) of the Revenue Act of 1942, *supra*] *Unused excess profits credit.*—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).

* * * * *

(26 U. S. C. 1952 ed., Sec. 710).

SEC. 711 [as added by Sec. 201 of the Second Revenue Act of 1940, *supra*]. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2), for such year except that the following adjustments shall be as follows:

(1) *Excess profits credit computed under income credit.*—If the excess profits credit is computed under section 713, the adjustments shall be as follows:

* * * * *

(J) [as added by Sec. 210(a) of the Revenue Act of 1942, *supra*] *Net Operating Loss Deduction Adjustment.*—The net operating loss deduction shall be adjusted as follows:

(i) In computing the net operating loss for any taxable year under section 122(a), and the net income for any taxable year under section 122(b), no deduction shall be allowed for any excess profits tax imposed by this subchapter, and, if the excess profits credit for such taxable year was computed under section 714, the deduction for interest shall be reduced by the amount of any reduction under paragraph (2) (B) for such taxable year: * * *

* * * * *

(2) *Excess profits credit computed under invested capital credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(L) [as added by Sec. 210(b) of the Revenue Act of 1942, *supra*] *Net Operating Loss Deduction Adjustment.*—The net operating loss deduction shall be adjusted as follows:

(i) In computing the net operating loss for any taxable year under section 122(a), and the net income for any taxable year under section 122(b), no deduction shall be allowed for any excess profits tax imposed by this subchapter, and, if the excess profits credit for such taxable year was computed under section 714, the deduction for interest shall be reduced by the amount of any reduction under subparagraph (B) of this paragraph for such taxable year: * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 711.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.41-1. *Computation of Net Income.*—

* * * * *

* * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 29.41-2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to

be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. * * *

* * * * *

Sec. 29.43-1. *"Paid or Incurred" and "Paid or Accrued."*—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Reve-

nue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * * *

Sec. 29.122-1. *Net Operating Loss Deduction.*—(a) *General.*—Section 122 provides the rules for the computation of the net operating loss deduction allowed by section 23 (s). The net operating loss deduction is the aggregate of the net operating loss carry-overs and carry-backs to the taxable year, reduced by certain adjustments to prevent the deduction of losses absorbed by income not taxed.

* * * * *

A fractional part of a year which is a taxable year under section 48 (a) is a preceding or succeeding taxable year for the purpose of determining under section 122 the first, second, or third preceding taxable year or the first or second succeeding taxable year.

* * * * *

(b) *Steps in computation of net operating loss deduction.*—There are three steps in the ascertainment of the net operating loss deduction. The first step is the computation of the net operating loss, if any, for the two preceding taxable years and for the two succeeding taxable years. The second is the computation of the net operating loss carry-overs to the taxable year from such preceding tax-

able years and the computation of the net operating loss carry-backs to the taxable year from such succeeding taxable years. The third is the conversion of the aggregate of such net operating loss carry-overs and carry-backs into the net operating loss deduction.

* * * * *

Sec. 29.122-2. *Computation of Net Operating Loss In Case Of Corporation.*—A net operating loss is sustained by a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions, additions, and limitations:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of long-term capital losses shall not exceed the amount includible on account of long-term capital gains, and the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of short-term capital gains. For any taxable year beginning after December 31, 1941, the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of such assets; and

(5) For taxable years beginning after December 31, 1941, there shall be allowed as a deduction the amount of excess profits tax imposed by subchapter E of chapter 2 paid or accrued within the taxable year, subject, however, to the provisions of section 122 (d) (6) (A), (B), and (C).

The application of this section may be illustrated by the following example:

Example. For the year 1942 the X Corporation, which makes its income tax returns on the calendar year basis, has gross income as defined in section 22 of $400,000 and deductions allowed by section 23 of $300,000, ex-

clusive of any net operating loss deduction. Included in gross income are long-term capital gains of $50,000 and short-term capital gains of $25,000. The corporation had long-term capital losses of $60,000 and short-term capital losses of $35,000, which are deductible to the extent of the capital gains, or $75,000.

The X Corporation also deducted $75,000 for depletion on a percentage basis. If depletion had been computed without reference to percentage depletion, the amount of such deduction would have been $5,000. For 1942 the X Corporation also had $35,000 of wholly tax-exempt interest, and paid $15,000 in interest on indebtedness incurred to carry the obligations from which such tax-exempt interest was derived.

On the basis of these facts the X Corporation has a net operating loss for the year 1942 of $110,000, computed as follows:

(1) Deductions for 1942		$600,000
Less:		
(2) Excess of percentage depletion over cost ($75,000 minus $5,000)		70,000
(3) Deductions adjusted as required by section 122 (d) (item (1) minus item (2))		530,000
(4) Gross income for 1942	$400,000	
(5) Plus tax-exempt interest minus interest paid ($35,000 minus $15,000)	20,000	

(6) Gross income adjusted as required by section 122 (d) (item (4) plus item (5))	420,000
(7) Net operating loss for 1942 (item (3) minus item (6))	110,000

APPENDIX B

Example 1

Illustration of

Computation of Corporate Income and Excess Profits Tax for Taxable Year Ended December 31, 1941

Income Tax

Net Income (also normal tax net income without deduction of excess profits tax)			$100,000 00
Less: Excess Profits Tax (last line below)			17,000 00
Normal tax net income			$ 83,000 00
Normal tax—24% of $83,000 00			19,920 00
Surtax net income		$83,000 00	
Surtax:			
On first $25,000.00 @ 6% of $25,000.00	$1,500		
On excess over $25,000 @ 7% of $58,000	4,060		5,560 00
Income Tax			$ 25,480.00

Excess Profits Tax

Excess Profits Net Income (same as first line above)			$100,000 00
Less:			
Specific Exemption		$ 5,000 00	
Excess Profits Credit (assumed)		50,000 00	55,000 00
Adjusted excess profits net income			$ 45,000 00
First $20,000 @ 35%	($20,000)		$ 7,000 00
Next $30,000 @ 40%	($25,000)		10,000 00
Excess Profits Tax			$ 17,000 00

Example 2

Illustration of

Computation of Corporate Income and Excess Profits Tax for Taxable Year Ended December 31, 1942

Income Tax

Net Income (without allowance of credit for income subject to excess profits tax (section 26(e))	$100,000 00
Less: Adjusted excess profits net income (line 4 below)	45,000 00
Normal tax net income	$ 55,000 00
Normal Tax—24%	13,200 00
Surtax—16%	8,800 00
Income Tax	$ 22,000 00

Excess Profits Tax

Excess Profits Net Income (same as first line above)		$100,000.00
Less:		
Specific exemption	$ 5,000.00	
Excess Profits Credit	50,000.00	55,000.00
Adjusted excess profits net income		$ 45,000.00
90% of $45,000.00		40,500.00
Computation of the 80% Limitation:		
Surtax Net Income (prior to sec. 26(c) credit)	$100,000.00	
80% of $100,000.00	80,000.00	
Less: Chapter 1 Income tax (line 6 above)	22,000.00	
Limitation of excess profits tax	$ 58,000.00	
Excess Profits Tax ($58,000 or $40,500, whichever is lesser)		$ 40,500.00

Example 3

Illustration of Accrual of Excess Profits Tax in Year of Net Operating Loss During Which Abnormal Income Is Attributable under Section 721 (d).

A corporation is on the accrual basis.

A corporation's net income for the calendar year 1944 was $200,000.00. The excess profits net income was also $200,000.00 which included $100,000.00 abnormal income attributable to 1945. For the calendar year 1945, A corporation sustained a net operating loss of $5,000.00. A corporation's excess profits credit was $50,000.00 for the years 1944 and 1945. The limitation on the tax provided by section 721 (d) (1) is not applicable.

Computation of Tax for 1945

Income Tax

Normal tax net income	($ 5,000.00)
Normal tax and surtax	-0-

Excess Profits Tax

Normal tax net income		($ 5,000.00)
Abnormal income from 1944 attributable to 1945		100,000.00
Excess profits net income		$ 95,000.00
Less:		
Specific exemption	$ 10,000.00	
Excess profits credit	50,000.00	60,000.00
Adjusted excess profits net income		$ 35,000.00
95% of $35,000.00		$ 33,250.00
Computation of the 80% Limitation:		
Surtax net income	($ 5,000.00)	
Plus: Abnormal income	100,000.00	
Adjusted surtax net income	$ 95,000.00	
80% of $95,000.00	76,000.00	
Less: Actual income tax under Chapter 1	-0-	
Limitation on excess profits tax	$ 76,000.00	
Excess profits tax (lesser of $76,000 or $33,250)		$ 33,250.00

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